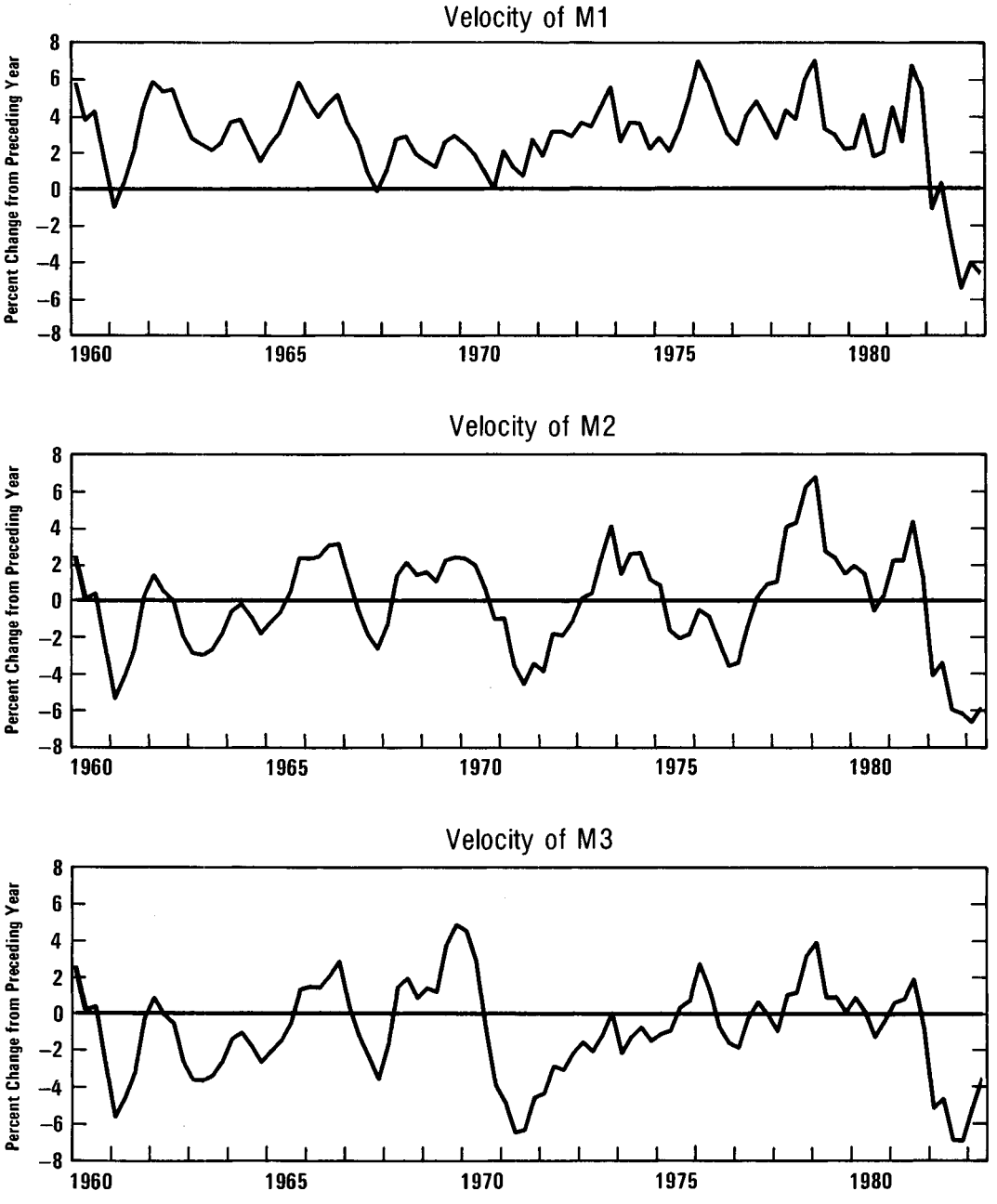
Figure 16.

Growth in Velocity of Money Aggregates



SOURCE: Congressional Budget Office.

return M1 to its February target range. Because the broader aggregates were within their target ranges and M1 growth was beginning to decelerate, severe tightening did not seem warranted, according to the central bank.

To reinforce this point, it raised the M1 targets to a range of 5 to 9 percent, and changed the base to the second-quarter 1983 average. The change in base period reflects the central bank's view that the relationship between M1 and GNP has changed. Because a significant portion of current money growth may finance accumulations of balances held as financial investments, rather than for making purchases, it held that the more rapid M1 growth witnessed earlier in the year was not excessive. Since the introduction of the new targets, however, M1 growth has exceeded even these higher levels.

The consequences of a given money growth rate ultimately depend upon the behavior of the demand for money, which is reflected in monetary velocity. Velocity—the ratio of GNP to money—measures the number of times on average that each dollar is used during the year in a transaction included in GNP. If the growth rate of velocity drops, more money growth is required to achieve a given GNP growth rate. As Figure 16 shows, all measures of velocity growth dropped precipitously during the recession. M1 velocity growth fell to negative levels for the first time in almost 20 years. The declines in the growth rates of M2 velocity (V2) and M3 velocity (V3), while not rare occurrences, were somewhat steeper and more prolonged than any in the last decade. This behavior implies that recent money growth has served to finance accumulations of idle balances rather than contributing to concurrent growth of GNP.

The decline in velocity has been particularly anomalous because this measure normally rebounds sharply in the first few months of an economic recovery, growing well above its long-run trend (see Table 10). Not only is current velocity growth lower than normal, however; it is also well below trend. 2/ This has led many economists to suspect that the amount of money that households and firms wish to hold for a given level of GNP has shifted upward significantly, perhaps in response to a reduction in inflationary expectations. There is good reason to expect that the demand for money increases when inflation is expected to decline: money retains

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2/ The advent of new instruments--especially the money market deposit account—appears to have contributed to the decline in velocity. However, the decline started well before the new instruments and is still evident after adjusting the data for growth in the new accounts. Moreover, the new instruments apparently had only minor impacts on M1 and M3.

TABLE 10. VELOCITY GROWTH FOLLOWING CYCLICAL TROUGHS

Number of Quarters Since Trough	V1		V2		V3	
	Historical Average a/	Current Recovery	Historical Average a/	Current Recovery	Historical Average a/	Current Recovery
One	5.9	-6.0	1.3	-11.0 b/	1.0	-2.2
Two	6.7	-2.7	1.3	-4.8	1.2	1.2
Three	5.2		0.7		0.5	
Four	5.5		0.4		0.2	
1960 to 1982 TREND	2.9		0.1		-0.7	

a/ Data represent averages of the four previous recoveries.

b/ M2 has been distorted by the introduction of money market deposit accounts. If the additional M2 growth attributed to these accounts was removed, the corresponding velocity growth would be -1.8 percent and 1.7 percent for the first quarter and half year of the current recovery.

more of its purchasing power when inflation is low, so the cost of holding money is lower. If moneyholders' expectations are still adjusting to the recent declines in the inflation rate, this could do much to explain the recent behavior of velocity. If so, velocity may not snap back to its former level, but rather may begin growing at its old trend rate once the adjustment in inflationary expectations is completed. In that case, recent money growth would not be inflationary, and only a moderate slowdown in future money growth would be needed.

Other economists, who believe that velocity is stable over long periods, contend that the relationship between money and income has been disturbed not by inflationary expectations, but rather by a cyclical increase in money demand related most directly to the recession. Since we are now in a strong recovery, they expect velocity to rebound in the near future. If so, continued growth in money at current rates would eventually lead to inflationary pressures. 3/ The monetary prescription suggested by this group

3/ This view found some support in a Federal Reserve study suggesting that the decline in velocity was due to increased precautionary money demand in the wake of rising unemployment. Improvement on the unemployment scene should therefore trigger a reduction in money

calls for a marked slowdown in money growth as soon as velocity begins growing again.

A third view of the causes of the recent slowdown in velocity emphasizes the time lags that often occur between changes in the money supply and changes in GNP. GNP may not yet have had time to increase proportionally with recent strong increases in the money supply. If this is true, velocity growth may return to more normal levels once a period of adjustment has passed.

The difficulty of resolving this issue is shown by Figure 17, which depicts movements in velocity since 1960 relative to its trend levels. Although the graphs show considerable short-run volatility, the various measures of velocity appear to be stable in the longer run around their respective long-run trends. This has been used to support the hypothesis that velocity will grow rapidly in the near term in order to return to its trend. If it does, then current money growth, if unchecked, may prove to be inflationary. But the graphs also show periods as long as five years during which the respective velocities were either above or below their trend levels. If the present is one of these below-trend periods, a snapback may not be imminent and fairly rapid growth in money may not be inflationary. The behavior of velocity remains one of the key uncertainties in the present and future conduct of monetary policy.

Recent Behavior of Interest Rates

Interest rates dropped sharply last summer and fall, but have recently moved upward slightly, and remain high for this phase of the business cycle (see Figure 18). Among the causes that have been suggested are:

- o Expectations of future inflation, which raise nominal long-term rates;
- o Continued fears that large federal deficits may conflict with increasing private credit demands and raise real rates;

3/ (Continued)

balances and a rebound in velocity. However, current data that show an improvement in unemployment and overall economic conditions, together with declining velocity, seem to argue the contrary.

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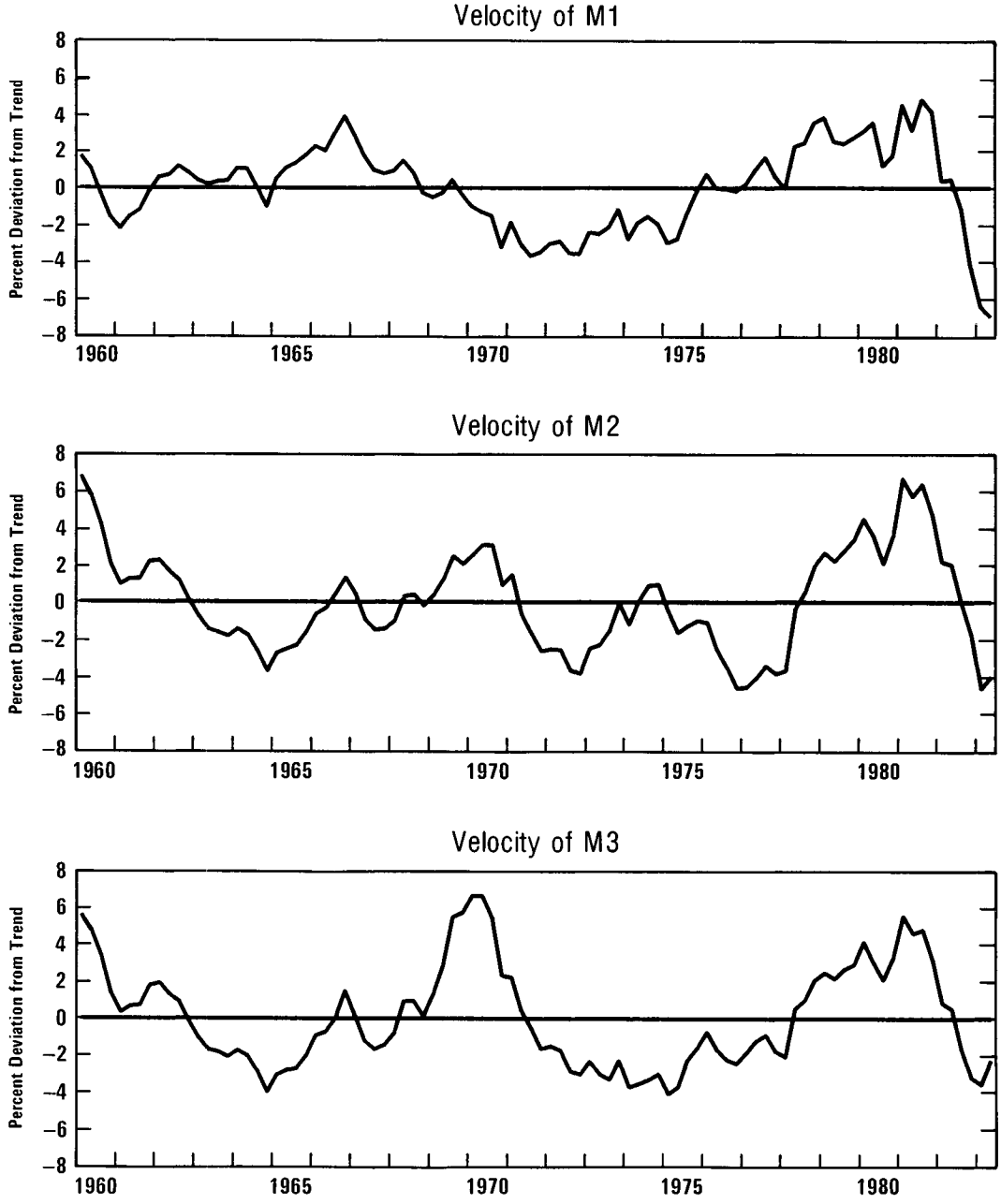
Figure 17.

Deviations from Trend of Velocity of Money Aggregates



SOURCE: Congressional Budget Office.

- The expectation that monetary policy may be restrictive in future years;

- Lingering uncertainty over whether and by how much policymakers will ultimately change budget deficits and monetary policy (this factor is discussed later in the chapter);

- Additional uncertainty about financial conditions stemming from recent volatility in money growth rates and interest rates;

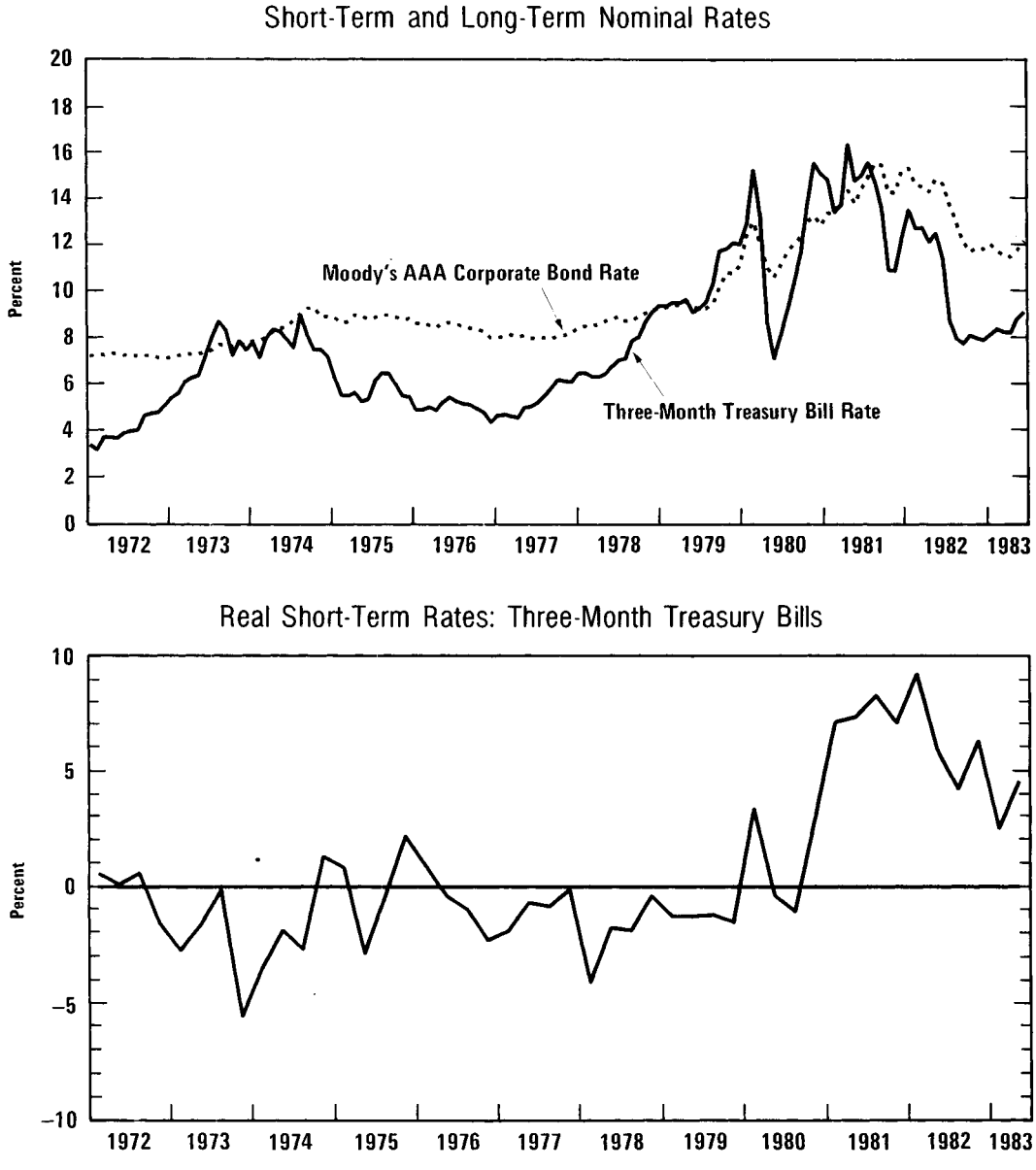
- The belief that monetary policy has failed to accommodate fully a shift in the demand for money, which also would tend to raise both nominal and real short-term interest rates.

It is possible that several of these factors have contributed to the persistently high levels of interest rates in the last six months. Some of the most important of these arguments are discussed below.

Inflationary Expectations. Analysts who look to expectations of inflation as the preeminent reason for current high interest rates offer two possible explanations. One is that inflationary expectations are changed slowly and have not yet fully embodied the recent improvements in prices. The other is that they stem from recent rapid money growth coupled with uncertainty as to whether the Federal Reserve will slow this growth in the future. The first explanation suggests that inflationary expectations and interest rates should continue to decline as the public becomes more accustomed to lower inflation rates. The second explanation is consistent with continued expectations of price increases and higher interest rates, especially if strong money growth continues and monetary policy remains unclear. However, both explanations are relevant only to longer-term rates; they do little to explain why short-term rates have been slow to fall.

Government Deficits. Many observers believe that a principal cause of today's seemingly high real interest rates is the expectation of very high federal deficits in the future. These deficits can be expected to increase future short-term real rates by intensifying the bidding for available funds. Since current long-term real interest rates are determined in part by expected future real short-term rates, this factor could do much to explain the current levels of rates. The argument is hard to verify statistically, however. One reason is that real interest rates are hard to measure, since doing so requires subtracting from observed interest rates an unobservable magnitude--the expected rate of inflation. A second difficulty in verifying the theory is that it may not have held during most previous years from which the available data are drawn. Before 1980, the Federal Reserve may have prevented deficits from raising short-term rates by "monetizing"

Figure 18.
Selected Interest Rate Measures



SOURCE: Federal Reserve Board; Congressional Budget Office.
NOTE: Real rates are nominal rates adjusted for inflation in the succeeding three months.

them. 4/ Both crowding out and monetization are discussed at greater length later in this chapter.

Future Monetary Policy. Some analysts expect Federal Reserve policy to be restrictive for several years in an effort to control inflation. This too implies that current long-term rates may be high because future short-term rates are expected to be high.

Shifts in Money Demand. Other economists have attributed the high interest rates to the Federal Reserve's failure to accommodate fully an increase in the demand for money. In previous reports, CBO has included simulations from standard money demand functions that provide evidence that an upward shift in demand has occurred. Failure to accommodate fully such an increase in demand would result in higher-than-normal real interest rates. An update of these results through the most recent quarter indicates an underprediction of as much as $30 billion or roughly 6 percent of M1. 5/ As a result, interest rates may have remained higher than otherwise would have been expected.

Whatever the reason for the high rates, it is somewhat surprising that the recovery in housing—a sector that is especially sensitive to interest rates—has been as strong as recent data indicate. Some of that rebound may be due to the release of pent-up demand when rates fell, and continued high real rates may inhibit further growth in those industries. Higher rates could also weigh heavily on the interest-sensitive investment sector as the recovery continues.

The Current Outlook for Monetary Policy

Entering the third quarter of the recovery, the Federal Reserve faces a dilemma. An attempt to slow the growth of money in the face of people's desire to hold more of it could raise already high interest rates and

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4/ For evidence in this regard, see Michael Hamburger and Burton Zwick, "Deficits, Money, and Inflation," Journal of Monetary Economics, vol. 7, no. 1 (January 1981); and Mickey D. Levy, "Factors Affecting Monetary Policy in an Era of Inflation," Journal of Monetary Economics, vol. 8, no. 3 (November 1981).

5/ These estimates were derived from dynamic simulations of money demand functions estimated through the fourth quarter of 1981. The computations are described in Congressional Budget Office, The Economic and Budget Outlook: An Update (September 1982).

adversely affect the recovery. High rates in the U.S. also make it more difficult for less-developed countries to refinance their external debts, a factor that may severely constrain the Fed's policy options. But continued rapid monetary expansion, if velocity growth increased, could mean a resurgence of inflationary expectations, higher nominal interest rates, and after some delay, increases in wage inflation.

In this quandary the Federal Reserve appears to be steering a middle course, though it is not clear what indicators it will rely on. Last September CBO outlined the pros and cons of policy indicators such as nominal GNP or interest rates. 6/ It assumed that the Federal Reserve would continue to announce a target range for the money aggregates but would be more flexible in setting the appropriate target range relative to changes in money demand (or equivalently, velocity). This assumption is still appropriate. In February, the central bank announced targets that not only accommodated money growth due to financial innovation but also allowed for slower-than-normal velocity growth. In its midyear report, the bank reaffirmed its growth ranges for the broader aggregates and retargeted M1 to accommodate the decline in velocity that occurred earlier in the year. Thus the Fed appears to be leaning toward promoting recovery, taking a somewhat greater risk of renewed inflation.

While increased flexibility may be necessary to offset the movements in velocity, this posture runs the risk of reducing the Federal Reserve's credibility as an inflation fighter. Erosion in credibility tends to increase inflationary expectations and market uncertainty, both of which put pressure on interest rates. In its midyear report the central bank reaffirmed its commitment to maintaining sustainable growth in the economy without increases in inflation. Still, the financial markets may have a different perception. Some economists believe that the bank would increase its credibility if it set goals for nominal GNP along with its monetary-aggregate targets.

FISCAL POLICY

The federal deficit has increased dramatically over the past two years, and is projected to remain at very high levels unless current policies are changed (see Table 11). The CBO baseline budget estimates, which exclude the effects of the First Budget Resolution for Fiscal Year 1984, show budget deficits in the neighborhood of $200 billion through 1986. If the policies of the resolution are put into effect, however, the deficit would decline by about $60 billion from 1983 to 1986.

6/ Ibid.

TABLE 11. UNIFIED BUDGET DEFICITS (By Fiscal Year)

	Actual	Estimate	CBO Projection		
	1982	1983	1984	1985	1986
	In Billions of Dollars				
February 1983 Baseline	111	194	197	214	231
August 1983 Baseline		207	196	205	214
Budget Resolution Policies including Reserve		207	192	180	146
Budget Resolution Policies excluding Reserve		207	183	176	143
	As a Percent of GNP a/				
February 1983 Baseline	3.6	6.1	5.6	5.6	5.6
August 1983 Baseline		6.4	5.5	5.3	5.1
Budget Resolution Policies including Reserve		6.4	5.4	4.6	3.5
Budget Resolution Policies excluding Reserve		6.4	5.1	4.5	3.4

a/ Reserve fund does not significantly affect budget figures when expressed as percent of GNP.

NOTE: For a detailed description of the February 1983 baseline estimates see CBO, Baseline Budget Projections for Fiscal Years 1984-1988, February 1983. For further details on the August 1983 baseline budget estimates see Appendix A of this report.

The recession widened the deficit by reducing tax revenues and increasing outlays for such programs as unemployment compensation. But the deficit would be very large even if there had been no recession and would tend to grow larger under current tax laws and spending policies. These developments are reflected in estimates of the structural deficit (that is, the part of the deficit that does not result from recession.) One such measure is the Standardized-Employment Deficit, the deficit as it would look if the unemployment rate were held to a relatively low rate of 6.0 percent.

Last February CBO estimated that the Standardized-Employment Deficit would rise steadily from 0.9 percent of cyclically-adjusted GNP in

TABLE 12. STANDARDIZED-EMPLOYMENT DEFICITS a/

	Actual 1982	Estimate 1983	Projection 1984	1985	1986
		In Billions of Dollars			
February 1983 estimate b/	29	69	91	128	159
August 1983 estimate c/	29	97	99	110	87
		As a Percent of Cyclically-Adjusted GNP			
February 1983 estimate	0.9	2.0	2.4	3.1	3.6
August 1983 estimate	0.9	2.8	2.6	2.7	2.0

a/ Unified budget estimate standardized at 6 percent unemployment. The estimates exclude the reserve fund. The programs included in the reserve fund would cost $9 billion in fiscal year 1984, $5 billion in 1985, and $4 billion in 1986. The impacts at the 6 percent unemployment rate that underlies the Standardized-Employment Deficit would be less.

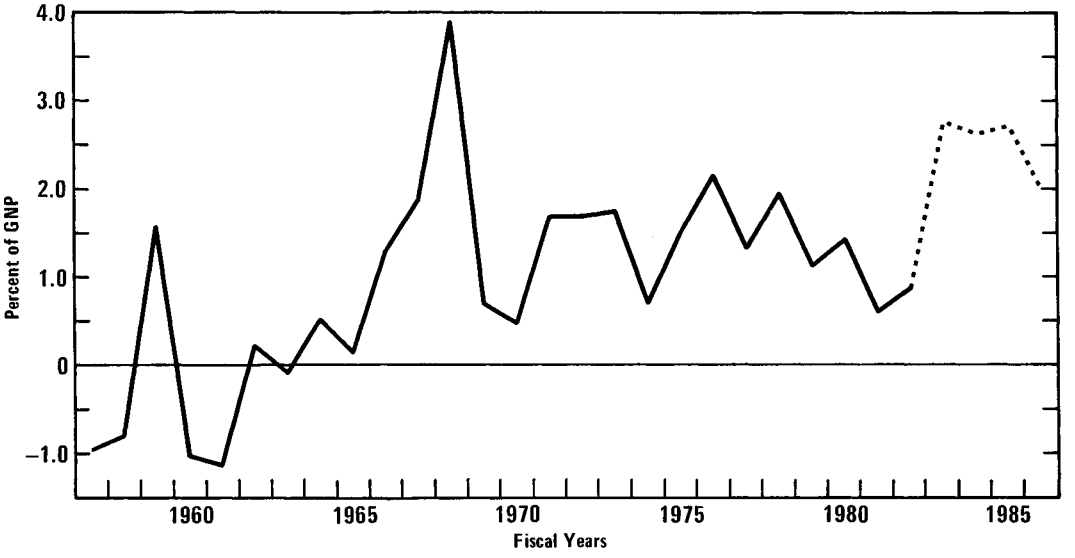
b/ Congressional Budget Office, The Outlook For Economic Recovery (February 1983). The 1982 levels have been revised to reflect revisions in economic data for that year.

c/ Assumes policies of First Budget Resolution for Fiscal Year 1984 passed last June.

fiscal year 1982 to 3.6 percent in 1986 under the policies then in place. Under some circumstances, such increases in the structural deficit could temporarily help stimulate a depressed economy. Over the long term, however, such large structural deficit levels can cause serious problems for the economy, as this discussion will point out. Faced with this prospect, the Congress has responded by passing a plan that would curtail structural deficits. The policies of the First Concurrent Resolution on the Budget for Fiscal Year 1984 would reduce the structural deficit significantly after 1984

Figure 19.

Standardized Budget Deficit as a Percentage of Standardized Gross National Product



SOURCE: Congressional Budget Office.

NOTE: Standardized at 6 percent unemployment.

while preserving its stimulus in the near term, as Table 12 shows. 7/ By 1986, the Standardized-Employment Deficit would decline to 2.0 percent of GNP with these policies. Nevertheless, this measure of the deficit would still be very large--far above the average of 1 percent of cyclically-adjusted GNP that has been observed since the late 1950s (see Figure 19).

Moreover, there are still reasons to be concerned that the policies of the First Resolution will not be implemented. The further legislation that is needed is embroiled in controversy, and the eventual outcome is highly uncertain. The budget outlined in the Resolution differs significantly from the President's proposal. Many members of Congress have suggested that the Congress may be unwilling to increase revenues as much as is called for

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7/ Current estimates of the Standardized-Employment Deficit for fiscal years 1983 and 1984 now actually exceed last February's figures, largely because of increased interest cost estimates and a variety of technical reestimates to revenues and outlays.

in the Resolution. The unusual degree of uncertainty over the deficit outcome may be reflected in current high interest rates. 8/

What Is Wrong with Large Structural Deficits?

Large budget deficits are not bad in all circumstances. When the economy is in recession, cyclical or structural increases in the deficit can bolster incomes and employment, mitigating the recession's severity, provided they are not offset by monetary policy.

The current deficit may be stimulating recovery substantially, since the Federal Reserve may not be following a monetary-targeting system. The projection of increasing deficits over the 1982 to 1984 period is a major reason for CBO's forecast of a recovery.

Large structural budget deficits may have serious economic consequences, however, particularly if they persist in the face of strong private demands. Under moderate Federal Reserve money growth policies, strong government and business credit demands would result in high real interest rates as government demand for credit absorbed a large share of the economy's savings, diverting or "crowding out" these funds from private capital markets. To the extent that business capital spending was discouraged, the ultimate effect would be a reduction in productivity and living standards.

If, on the other hand, the Fed tried to hold down real interest rates and help finance the larger deficits by converting a significant share of the Treasury's new debt into money, or "monetizing" it, the ultimate outcome might be an accelerating inflation as well as reductions in investment and productivity growth. The large prospective deficits, which are due largely to rising interest outlays, make the prospect of monetization seem more likely. Crowding out and debt monetization, then, are the major ways in which deficits threaten to affect the economy.

8/ Financial assets may become less attractive to investors who dislike risk if the uncertainty surrounding the budget outcome increases. This may be true even if the particular budget outcome that these investors consider most likely does not change. This is because financial markets increase the expected real yield on risky securities relative to that on safe ones by enough to compensate risk-averse investors for uncertainty. This increase in expected yield is called the "risk premium."

How Much Crowding Out Do Deficits Cause?

It would be easy to overestimate the amount of productive investment that a given deficit is likely to displace, even under a "tight" monetary policy. This is because:

- Changes in tax provisions or spending programs that increase deficits may also increase private saving.

- Increases in real interest rates that accompany large deficits attract foreign capital.

- Crowding out may affect investment in housing and other types of spending more strongly than business investment because the latter may be determined primarily by the strength of overall demand, rather than by interest rates. If so, the consequences for productivity may be less severe than they would if business investment were more heavily affected.

Savings Impacts of Budget Programs. Many of the particular changes in tax provisions and spending that underlie recent increases in structural deficits may also temporarily increase corporate and personal saving rates. The more liberal 1981 provisions governing tax deductions for depreciation of business capital, for example, entailed a large revenue loss even after they were scaled back in 1982. The reduced business tax liabilities deriving from this legislation should lessen the amount of near-term business borrowing to finance any given investment; thus it may temporarily increase business saving at the same time that it increases government borrowing.

There are several ways in which personal savings, too, may be affected by current budget deficits. The recent cuts in marginal personal income tax rates and enactment of tax provisons for Individual Retirement Accounts and Keogh Plans, all of which increase the deficit significantly, may also increase personal saving rates, at least temporarily. The saving rate may also be increased by the growing share of the deficit that is accounted for by interest outlays. A large part of these outlays occurs because nominal interest rates contain a premium to compensate bondholders for expected inflation. Interest outlays that reflect this premium may be saved by bondholders, since such saving is necessary to prevent the real value of their wealth from being eroded by inflation. Increases in interest outlays that reflect rising real interest rates may also be associated with increases in the personal saving rate, since there is some evidence that saving responds to changes in interest rates.

These savings impacts, if they are significant, should be reflected in observed saving rates in the absence of offsetting impacts from other factors. As Chapter II has shown, however, the measured personal saving rate has recently fallen to very low levels by historical standards. Thus, there is as yet little direct evidence that these savings impacts are occurring, though it is possible that their effects are being masked by other factors serving to depress the overall rate.

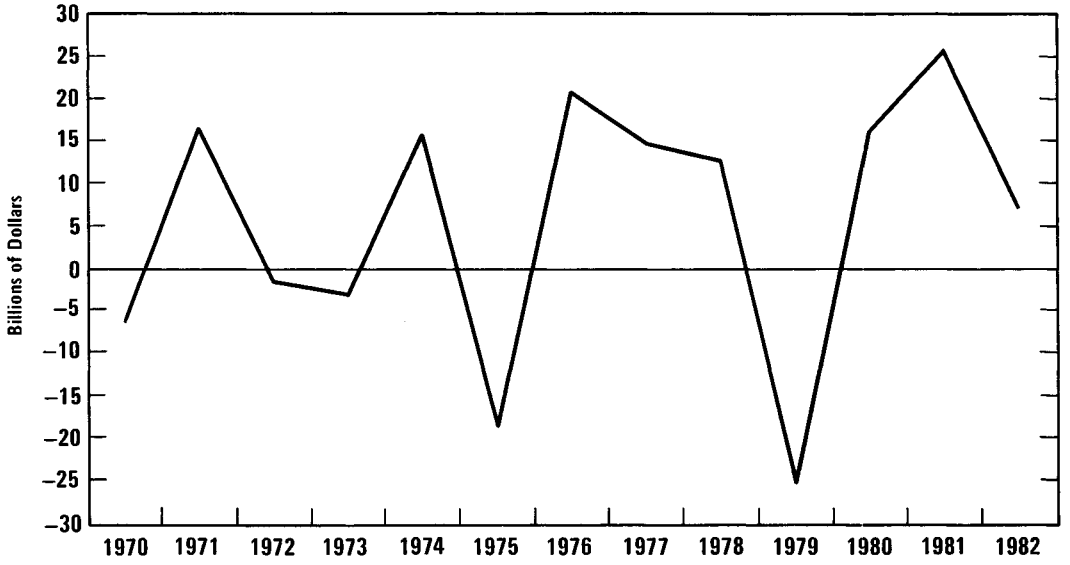
A different short-run savings impact, one that changes the total quantity of saving without necessarily affecting the saving rate, can occur in response to increases in the deficit itself if they stimulate an expansion in GNP. As this discussion has already suggested, budget deficits may increase economic activity if monetary aggregates are not controlled tightly. Such increases in overall income give rise to new savings flows, and this lessens the competition between government and private borrowing.

Foreign Financing of U.S. Deficits. Because U.S. interest rates have recently been high relative to those in other countries, significant amounts of foreign saving have been flowing into the United States. As Figure 20 shows, the increase in net foreign-owned assets reached $26 billion during 1981, and was still $7 billion in 1982 despite lower U.S. interest rates. While such inflows augment the flow of funds available for financing both the budget deficit and private investment, they also have negative impacts. Such capital flows are quite volatile and may reverse direction if economic conditions change. The inflow of foreign capital may also raise interest rates abroad, causing political as well as economic difficulties there; indeed, such inflows reduce crowding-out of U.S. investment largely by transferring the impact to other countries. Private capital inflows also tend to raise the exchange rate of the U.S. dollar (if central banks do not intervene), causing reductions in U.S. exports, increases in imports, and costly shifts of displaced resources into other sectors.

What Spending Is Crowded Out? Even if some crowding out is occurring, it may affect types of spending other than business investment. As the discussion above points out, for example, foreign capital inflows may protect investment from a shortfall in financing, but ultimately only at the cost of reductions in net exports instead. State and local government spending, housing, or consumer spending, all of which are sensitive to interest rates, may likewise be affected instead of private business investment, which may respond more strongly to overall demand than to interest rates. This possibility is accentuated by the fact that recent budget policy changes increased incentives to invest funds in business capital instead of housing and consumer durables. The acceleration of depreciation schedules and the reductions in individual income tax rates under the Economic Recovery Tax Act of 1981, in particular, reduced the overall cost

Figure 20.

Change in Net Foreign Assets in the United States



SOURCE: U.S. Department of Commerce.

NOTE: Figures represent year-to-year change in foreign holdings of U.S. assets.

of business capital at given levels of interest rates and at the same time reduced the relative value of tax preferences for housing. 9/

Monetization

Large deficits may be "monetized" if the Federal Reserve buys large quantities of new Treasury debt issues itself, thus converting them into bank reserves and therefore into sharp increases in the money supply. This would increase inflation. The process of halting such acceleration in inflation is

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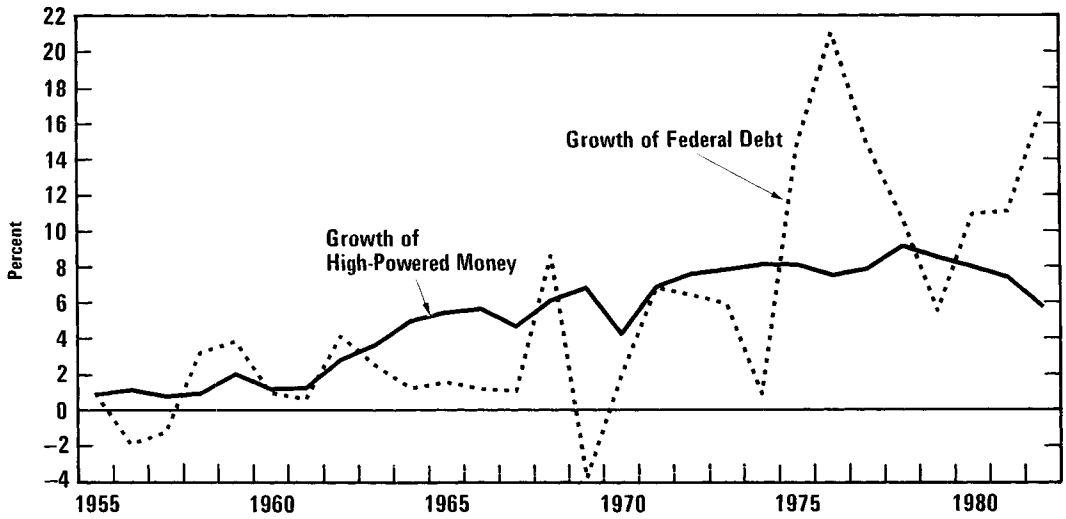
9/ While housing and consumer durables also contribute to living standards, favorable treatment of such expenditures in U.S. tax laws may imply that additional spending, especially on high-income housing, may contribute less to consumer welfare than would additions to the stock of business capital.

Figure 21.
Monetization of the Debt



SOURCES: Federal Reserve Board; Congressional Budget Office.
NOTE: High-powered money is bank reserves plus currency held by the public. Federal debt is the publicly-held interest-bearing debt.

likely to involve increases in unemployment and real interest rates and reductions in output and investment, much as it has in the past. Thus, persistent monetization threatens the economy with the compounded problems of inflation and eventual economic contraction.

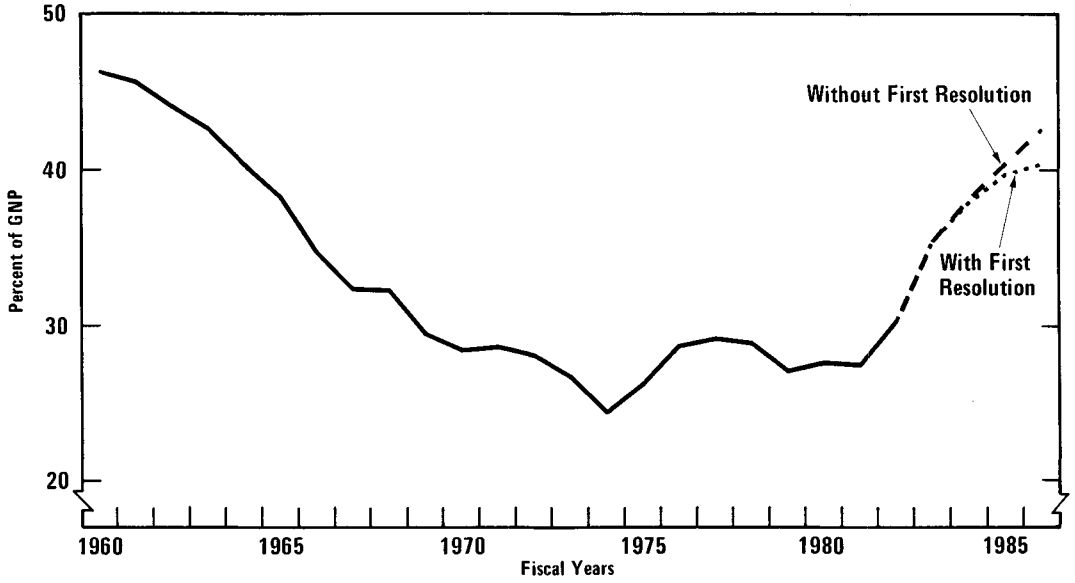
If financial markets react to large projected deficits by anticipating that they will be monetized, longer-term nominal interest rates may rise to reflect the expected inflation. There has been little recent evidence of monetization, however. As Figure 21 shows, the growth of "high-powered" money—that manipulated directly by the central bank—has slowed sharply since 1978, while the publicly-held debt has grown strongly.

How Much Deficit Reduction Is Enough?

Ultimately, the economic problem created by large deficits is that the federal debt may grow faster than the economy's capacity to absorb it. For this reason, many analysts argue that a compelling quantitative criterion or target for deficit reductions is that they should overcome the recent tendency for the debt to grow faster than the trend rate of growth in GNP.

Figure 22.

Publicly Held Federal Debt as a Percent of Gross National Product



SOURCE: Congressional Budget Office.

As Figure 22 shows, the ratio of the publicly-held federal debt to GNP has grown significantly since 1981, and is projected to continue growing strongly if deficit-reducing measures such as those in the First Concurrent Resolution are not implemented. With such measures, however, this growth should slow significantly by 1986. 10/ The First Resolution, then, would accomplish an important change in the budget outlook. 11/

10/ CBO's calculations of the growth tendency of the debt/GNP ratio over the distant future suggest that the ratio should stabilize under the policies contained in the First Resolution at a level close to that projected for 1986. For a discussion of the long-run analysis on which this estimate is based, see James Tobin, "Budget Deficits, Federal Debt, and Inflation in the Short and Long Runs," in Conference Board, Toward a Restructuring of Federal Budgeting (December 2, 1982).

11/ The President's February budget would have similar beneficial impacts, assuming that all contingent revenue increases took effect. See Congressional Budget Office, An Analysis of the President's Budgetary Proposals for Fiscal Year 1984 (February 1983).

This change might not be permanent, however. The debt could again begin growing significantly faster than GNP if a slowdown in the economy's growth or an outright recession during the late 1980s was accompanied by an increase in real interest rates (see Box).

Possible Adverse Impacts of Deficit Reductions

As this discussion has shown, measures to reduce future deficits from the levels projected under current policy are essential to avoid long-term economic problems. However, deficit reduction measures would not be costless. Depending on the specific measures adopted and other economic conditions, there might be effects both on aggregate demand (temporarily) and on economic incentives affecting long-run growth.

Deficit-reducing measures would directly reduce the incomes of taxpayers, government workers, recipients of transfers, and others. As a result, businesses might reduce investment, anticipating reductions in their markets. If not offset by other factors, these developments might temporarily weaken GNP. There is also, however, one way in which spending cuts and tax increases may work to strengthen the economy in the short run if the measures are put into effect after a delay. They may reduce current long-term rates because of their expected impacts on future inflation and short-term interest rates. This decline in current long-term rates may stimulate growth in housing and business investment, and, if the growth is not offset by other factors, cause overall GNP to rise.

Quite apart from such potential complications in the short-run outlook, ill-chosen deficit-reducing measures may have adverse impacts on long-run growth that at least partially offset their intended effects. Measures to increase revenues may reduce the flows of savings, of risk-taking, or of labor supply if they have incentive-reducing impacts. Spending cuts may have similar perverse impacts, especially if they fall on programs of government investment that contribute to productivity growth in the long run.

Most analysts would argue that the favorable long-run impact of deficit cuts working through reductions in government borrowing and consequently in interest rates should be strong enough to outweigh their possible adverse impacts on incentives. Still, the best long-run policy would avoid affecting incentives by enacting deficit cuts that do as little as possible to raise marginal tax rates or reduce government investment.

CONCLUSION

The outlook for interest rates, monetary growth, and budget deficits has seldom been as complicated and uncertain as at present. Real interest rates have remained high, in part because of the anomalous behavior of the demand for money and the size of current and projected budget deficits. The future courses of both monetary and fiscal policy remain highly unsettled: the Federal Reserve faces conflicting pressures over how to react to recent strong money growth, and the budget is engulfed in controversy. The resulting uncertainty may be another reason that interest rates remain high.

Progress on either front—monetary or fiscal—will require progress on the other. Otherwise, efforts to reduce the growth of the federal debt may be offset by rising interest rates, while efforts by the Federal Reserve to hold down interest rates may be undermined by rising deficits.

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WILL THE FEDERAL DEBT OUTRUN THE ECONOMY?

Some economists have observed that present policies are bringing the budget precariously close to the point at which larger and larger deficits are required merely to finance outlays for interest on the debt. Should this occur, it could spur strong growth in the federal debt and lead to financial stress as well as serious problems of crowding out and debt monetization unless holders of the debt help finance the debt increases by saving virtually all of the interest payments they receive.

Whether a given debt growth rate carries this threat depends on whether it exceeds the growth in the economy's capacity to absorb debt—that is, whether the debt grows faster than GNP. CBO estimates that although the debt may not grow faster than GNP indefinitely, there is a serious risk that a substantial amount of such growth could occur before finally coming to a stop. This risk will be significantly reduced if the Congress implements a program of deficit reductions like those entailed in either the First Concurrent Resolution or the President's February budget.

The growth tendency of the debt relative to GNP can be measured in terms of a few essential variables. The annual increase in the publicly held federal debt is roughly equal to the deficit (including off-budget borrowing). If the deficit were exactly equal to outlays for interest on the debt, the growth rate of the debt would be easy to measure—it would be the interest rate. In that situation, the growth rate of the debt would be less than that of GNP whenever the interest rate was less than GNP growth. Since the deficit tends to be larger than interest outlays, however, the growth rate of the debt is usually higher than the interest rate. As a result, the debt can grow faster than GNP even when the interest rate is below GNP growth. One way to stop the growth of the debt/GNP ratio is to make sure that the deficit is less than interest outlays. If the deficit is sufficiently smaller than interest outlays, the debt/GNP ratio will fall even if the interest rate exceeds the GNP growth rate.

Figure 22 shows CBO's current projections of the debt/GNP ratio. The ratio is projected to grow strongly if the First Concurrent Resolution is not implemented, despite the fact that GNP growth in CBO's projection exceeds the levels of interest rates. This debt growth occurs because projected deficits far exceed interest payments. Under the First Resolution, on the other hand, the growth of the ratio slows sharply by 1986.